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Selecting The Proper Capitalization Rate

The Author Examines The Components Which Make Up The Capitalization Rate

By JOHN C. TREDWELL

THE question of capitalization rates, unfortunately, has not received from appraisers generally the consideration it deserves.

There is still too great a tendency on the part of many appraisers to select a capitalization rate which will produce the result desired and then justify the rate selected by some such statement as, "In my opinion this is the rate required to attract capital to an investment of this type."

The influence of the capitalization rate on the valuation is shown in the following table:

Net Income	Cap. Value at 7%	Cap. Value at 8%
$ 500	7,143	6,250
1,000	14,286	12,500

An increase in the capitalization rate from 7 percent to 8 percent results in a decrease of approximately 12½ percent while a drop from 8 percent to 7 percent in the rate produces an increase of approximately 14½ percent. If there is agreement that competent appraisers should normally reach opinions within 10 percent of one another, then a difference of 1 percent in the selection of capitalization rates alone will produce a difference greater than 10 percent.

Interest is rent paid for the use of money or payment for the use of capital or capital goods.

The rate charged for its use will vary with the supply and demand and the risk involved in its use.

Interest is limited in this discussion to the return on wealth accumulated by the industry of man as distinguished from the bounty of nature.

TOO little attention has been paid to the question of capitalization rates, in the opinion of the author. In this article he analyzes those factors which affect the capitalization rate and also describes the influence of the capitalization rate on valuation. Mr. Tredwell is a member of the appraisal firm of E. A. Tredwell & Co., Inc., New York. He is chairman of the sub-committee on Education of the American Institute of Real Estate Appraisers and has served on the faculties of the Universities of Chicago and Pennsylvania and of Columbia University. This article is reprinted from the Review of the Society of Residential Appraisers.

Before attempting to discuss those matters which affect the interest rate, it is necessary to examine the components which make up the rate. Loosely speaking, these components may be designated as:

1. The safe interest rate.
2. The rate for risk.
3. The rate for management or reward for enterprise.

The sum total of these is called the "over-all" interest rate.

The safe interest rate may be defined as that interest rate obtainable from the highest grade of bonds, such as long-term governments. United States Government bonds represent the ultimate in safety, both as to regularity of interest payments and the repayment of principal at maturity. The Federal Government has first claim on the nation's resources. Its bonds therefore represent the safest type of investment.

The rate for risk is that portion of the rate which is added to the safe interest rate to compensate for the element of hazard involved in the use of the principal. When one lends capital he charges something extra for risk and calls it interest. If the obligation is met, he gets a higher return as a compensation for the danger of getting a lesser return or nothing. The extra charge is a premium for the risk accepted—an increment in excess of the safe interest rate—and which is warranted because of the hazard that there may be a loss in either interest or principal.

Examples of this extra premium for risk and its necessity are ever before us, such as higher rates for specialty buildings, second mortgages, and the like.

The rate for management is that portion of the rate added to compensate for the cost of the work involved in managing the investment.

In the case of a lending institution, expense must be incurred in investing its funds and collecting the payments which includes such items as rent, clerk hire, and so on.

The rate for management should vary inversely with the volume of funds loaned.

The "over-all" rate is the matter of primary importance to the appraiser, rather than its make-up. It is that rate of interest demanded, or received, by the investor for the use of his capital. Stated differently, it is that single rate applicable to land and building as a unit. The owner or prospective purchaser of income property is not so much concerned with the rates earned by the land, and by the structures separate and apart from each other, such as 6 percent on land and 8 percent on building. Rather is his concern with the return from the property as a single income-producing unit.

Market Value

In estimating market value by way of the capitalization process, the best indicator of what the overall rate may be for any type of property in any particular district is to calculate it by dividing the net income by the sales price at which comparable properties have sold, during a time of comparable economic conditions. For illustration, if an apartment house having a net income of $4,500 per annum (net to land and building after depreciation) were sold for $60,000; and if this sale were normal in all respects, and other comparable transactions reflected a similar rate, then it might be said that 7.5 percent was the proper rate for this type of property, in this area, at that time.

During times of so-called normalcy, or economic equilibrium, as evidenced by a reasonably static price level, the over-all capitalization rate for any particular type of property in a particular area will fluctuate but little above or below its norm. However, the over-all rates for different types of property, and for similar properties in different districts may be quite different. A changing price level, and all it implies will occasion an inverse change in the normal over-all interest rate, i. e., when prices are rising, the rate will fall: When prices are falling, the rate will rise.

Split rates are separate interest rates such as 5 percent for land and 7 percent for building employed in residual appraisals, and otherwise.

It is not uncommon for appraisers arbitrarily to employ such split rates, irrespective of the ratio of land and building, the adequacy of the improvement, etc., although the practice is subject to severe criticism.

Whenever split rates are so used, the over-all rate, which they reflect, should be determined and used as a check.

The lessor's and lessee's rates by which is meant those rates at which their respective incomes should be capitalized now command attention.

Ground Leases

In long-term ground leases the customary security for the faithful performance of its covenants, e. g., payment of rent is a building to be created by the lessee at its own expense. This the lessee subleases to tenants. Of the rentals collected from tenants, the lessee must first pay the ground rental to the lessor before any income can be imputed to his structure.

The land thus occupies a preferred position, like a first mortgage. If, for illustration, rents decline, then the income to the building may disappear entirely without affecting the income to the land. Conversely, a rising price level, and advancing rents, bring about a greater income to the building (and management) also without affecting the income to the land.

"IN estimating market value by way of the capitalization process, the best indicator of what the over-all rate may be for any type of property in any particular district is to calculate it by dividing the net income by the sales price at which comparable properties have sold, during a time of comparable economic conditions," declares Mr. Tredwell. He points out that during periods of economic equilibrium the over-all capitalization rate of any type of property in a particular area will fluctuate but little, while a changing price level will occasion an inverse change in the normal over-all interest rate.

It is now seen that great changes may occur in the earnings of the property without affecting the earnings of the land. Hence the land is subject to a lesser risk, and the rate employed in capitalizing its income (the lessor's interest) is correspondingly small. On the other hand, any changes in the net income to the property are first reflected in the income of the structure. Hence the income to the building is subject to greater risk, and therefore warrants a higher rate.

And, in conclusion, various rates may be applicable in the same property. The rate to land on long-term ground leases usually will be the lowest; the rate applicable for the property on a long-term building lease will be higher; and the rate for capitalizing 5 or 10-year store leases will be the highest.

The Proper Rate

The proper interest rate applicable under any specific condition is that rate necessary to attract capital to the investment, in view of the hazards environing the use to which the funds are dedicated. Some of these hazards are general economic conditions (stability of the price level, or otherwise); the ratio of land value to building value; the stability of the district; type of property, etc., etc.

The sinking-fund interest rate must be low for the reason that such accounts contemplate the compounding of interest over long periods of time. Financial history has adequately shown that money cannot be accumulated at high interest rates, that is, higher than the average compound rate of increase of the wealth of the nation. This approximately corresponds to the safe interest rate hereinbefore discussed and which in turn tends to fix the savings bank interest rate.

Average Earning Rate

History also has conclusively demonstrated that, over long periods of time, money cannot be safely invested at a compound interest rate of more than 3.5 percent per annum. At the present time the rate is much less. Why this should be so is not so important as the fact that it is so. Of course there may be terms of relatively short duration during which higher rates can be earned, but surely and inevitably there come times when losses, either of principal or of interest, must be absorbed. This reduces the long-term average earning rate.

In conclusion, the rate at which money can be compounded, over reasonably long periods of time, say 30 years, cannot be in excess of the increase in the wealth of the nation.

For reversions, that is, the rate at which future amounts should be dis-

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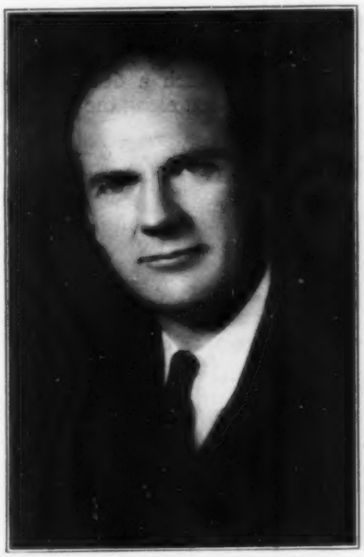
CONVENTION TO HEAR PROMINENT ECONOMIST

Dr. Claude L. Benner, Vice President and Chairman of the Finance Committee of the Continental American Life Insurance Company of Wilmington, Delaware, will address the general session of MBA's 27th annual Convention on October 3 on "Some Economic Consequences of the Present European War."

Dr. Benner is particularly well equipped to discuss this topic because he has been engaged in economic research since his graduation from the University of Michigan in 1920. Following his graduation from Michigan, Dr. Benner joined the faculty of his alma mater. He is a former member of the research staff of the Brookings Institution, Washington, D. C., and was once head of the Department of Economics at the University of Delaware.



DR. CLAUDE L. BENNER

In 1928, Dr. Benner joined the Continental American Life Insurance Company as an economist. He is director and member of the Trust Committee of the Equitable Trust Company of Wilmington and Chairman of the City Mortgage Loan Conference. He also serves as a Special Lecturer on Finance at the Wharton School of the University of Pennsylvania.

Dr. Benner is the author of "The Fear of Inflation and its Relation to Life Insurance" and "The Federal Intermediate Credit System," and co-author of "Ten Years of Federal Intermediate Credits."

FORECAST DECLINE IN POPULATION

The National Resources Board warns that the United States is approaching an era of "stationary or decreasing population," resulting from a declining birth rate and immigration restrictions.

The Board estimated that the 1940 census would show a population of 131,993,000, compared with 122,775,046 a decade ago. It placed the 1980 population at 158,335,000, due to an estimated increase of 234 percent in the number of persons over the age of 65, and twice the number of persons between the ages of 45 and 64 as there are today.

In an inventory of the human and physical resources upon which the United States can depend for national defense, the board found that the nation's inventive genius is one of its most valuable assets.

PLAN ENTERTAINMENT FOR THE LADIES

An extensive program of entertainment is being planned for the wives of MBA members who attend the 27th annual Convention of the Mortgage Bankers Association of America which will be held at the Drake Hotel in Chicago on October 2, 3 and 4. Early this month the Ladies Entertainment Committee held its first meeting and discussed plans for entertaining the many wives of MBA members who will be in Chicago for the Convention.

The committee's program is not yet complete but definite plans have been made for luncheons on both Thursday and Friday. On Thursday, October 3, the ladies will be entertained at a luncheon at the Southshore Country Club in Chicago. A luncheon and a style show is scheduled for Friday afternoon at Marshall Field's, Chicago's largest department store.

The Ladies Entertainment Committee is headed by Mrs. Hugh Riddle. Mrs. Fred Kramer and Mrs. H. R. Goodwillie are co-chairmen.

Few HOLC Borrowers Ask Lower Payments

Less than 30 percent of the original HOLC borrowers still on the books have asked for lower payments and extended loans under the Mead-Barry Act, according to John H. Fahey, Chairman of the Federal Home Loan Bank Board. The 600,000 borrowers have been able to make their payments with no more aid than was provided under the Act as passed by Congress.

Chairman Fahey reports that arrangements have been completed with more than 275,000 borrowers to prevent future tax delinquencies, a primary cause of foreclosure. Under the plan the borrower pays a monthly sum toward taxes.

FCA TO DEFER LOAN PAYMENTS

The Farm Credit Administration recently announced a decision to defer principal payments on federal land bank loans in "meritorious" distress cases. The new policy will take effect as soon as the individual federal land banks have formulated procedure for its application. Officials of the FCA said that deferments would be available only to borrowers who in good faith had made every possible effort to make their payments.

OVERHANGING REAL ESTATE

The Federal Home Loan Bank Board reports that one out of every ten residential properties "overhanging" the real estate market was sold to a private owner in 1939.

It was estimated by the Board's Division of Research and Statistics that insurance company holdings of 1-to-4 family homes dropped from $286,000,000 to $247,819,000, or 13.6 percent, while their apartment house holdings increased from $289,415,000 to $315,688,000.

During 1939, the residential properties held by insured commercial banks dropped from $223,358,000 to $182,692,000. Allowing for the holdings of uninsured banks, the amount of residential properties directly and indirectly owned by commercial banks is estimated to have declined during 1939 from $290,000,000 to $245,000,000.

The Board reported that, to a large extent, the real estate overhanging remains concentrated in the northeastern section of the country in the states of New York, New Jersey, Pennsylvania and Massachusetts.

To stimulate building, Uruguay has exempted from taxation for ten years all buildings completed before 1944.

A Suggested Method Of Avoiding Reversions

The Author Outlines A Method To Avoid Reversionary or Re-Entry Clauses in Restrictions

By McCUNE GILL

THE statutes of New York, New Jersey, Massachusetts, Ohio, Kentucky, and some other States, governing the mortgage investments of life insurance companies, forbid investment in mortgages on property that is subject to building restrictions containing reversionary or re-entry clauses. In some States, such as Connecticut, Iowa, Missouri, Pennsylvania, counsel for life insurance companies hesitate to accept mortgages on titles subject to reversionary rights because the mortgage may not be a lien on an "unencumbered title" as required by their statutes. This results in such companies being denied some of the best mortgages in many localities.

The local loan representatives must seek waivers from the grantors or the heirs of the deceased grantors in deeds containing reversion clauses. Sometimes the heirs cannot be found or the corporation has gone out of business. Frequently the reversioners demand an exorbitant price for a waiver. Occasionally in a recent development the grantor will refuse to waive because he wishes to control the loans himself. In all cases the attempt to secure waivers involves delay and expense.

Obviously the life insurance lending business would be greatly benefited if some way out of this reversionary tangle could be discovered, for repeal of the laws is hardly possible.

It has occurred to the writer that a method might be devised which would involve a mere agreement on the part of the mortgagor or borrower, whereby he would convey away his right to violate the restrictions. That is, he would, during the life of the loan, be a stranger to the property so far as the unauthorized use of the land is concerned.

The form of trust deed in use in many States seems to lend itself to this purpose. In these States the mortgagor conveys the title to a trustee named in the deed of trust. The trustee then leases the property back to the mortgagor at a rental of one cent per month. If any future default occurs in the payment of notes or in the performance of any of the covenants of the deed of trust, the lease immediately terminates and the trustee is entitled to possession.

MR. GILL, who has developed a plan for avoiding reversionary clauses, is Vice President of the Title Insurance Corporation of St. Louis and a member of MBA's Board of Governors. He reports that the statutes of several states forbid investment in mortgages on property that is subject to building restrictions containing reversionary or re-entry clauses. In other states, Mr. Gill points out, life insurance companies hesitate to accept mortgages on title subject to reversionary rights because the mortgage may not be a lien on an "unencumbered title" as required by their statutes. This provision, he says, results in such companies being denied some of the best mortgages in many localities.

If we should add to this leasing clause, a provision to the effect that the trustee leases the property to the mortgagor for the sole purpose of using the property in the manner prescribed by any restrictive covenants, and for no other use, and stating that any forbidden use would be considered unauthorized by the trustee, any such use would be the act of a stranger to the title and could not result in a reversion or forfeiture, so far as the trustee or mortgagee are concerned.

Of course, such a plan must receive the approval of the lender's counsel, and the counsel for the insurance departments of the various States. But as everyone seems anxious to approve such loans, where the actual possibility of violation of restrictions seems slight, a legal method of avoiding the possibility of reversion should be favorably received.

It might be claimed that there still exists a possibility of the trustee consenting to a violation. This is overcome by naming someone as trustee who is friendly to the lender which would prevent any consent to a violation by the trustee.

The form of such a deed of trust would be somewhat along the following lines:

"This Deed of Trust — between (mortgagor) party of the first part and (trustee) party of the second part, and (lender) party of the third part; Witnesseth, That party of the first part in consideration of the debt and trust hereinafter described and of the sum of One Dollar paid by party of the second part, does Grant, Bargain and Sell to Party of the Second Part (the Property). To have and to hold unto the party of the second part and possession of the property is now delivered to said party of the second part. And the said party of the second part hereby leases and lets the property to said party of the first part at a rental of one cent per month, for the purpose of occupancy by party of the first part in strict accordance with any and all covenants and restrictions governing the use or occupancy of said property, and until and only until the beginning of any contrary or unauthorized use thereof. And any attempted use contrary to or in violation of such restrictive covenants shall be considered as the act of a stranger to the title and wholly unauthorized by the party of the second or third parts herein, and shall immediately terminate this lease, and all rights of possession shall forthwith vest in the party of the second part. If not so terminated said lease shall continue until default be made in the pay-

ment of the notes herein described or in the performance of any of the covenants in this deed of trust contained. Upon the termination of said lease for any of the aforesaid reasons the party of the first part will immediately surrender peaceable possession of the premises to the party of the second part, who may thereupon rent the same and exercise all other rights of a fee simple owner."

Legal Questions

Several legal questions arise in connection with the above suggestions. One is whether such a leasing clause actually creates a true relation of landlord and tenant such as will be recognized by the courts. The other question is whether a violation of restrictive covenants by a tenant against the wishes of the landlord will result in a reversion to a grantor in a previous deed.

On the first point the Missouri courts have held that a lease clause in a deed of trust creates a real tenancy. It is also further stated in that case that "special provisions of various kinds to suit the convenience of the parties may be inserted in a mortgage. Jones on Mortgages, Sec. 79." So real, in fact, is this relation of landlord and tenant, that the trustee can obtain possession in a landlord's unlawful detainer action in a justice of the peace court. And a purchaser at a foreclosure sale under the deed of trust may likewise maintain an action of unlawful detainer against the grantor of the deed of trust.

On the other point as to whether a violation of a restriction by a tenant can involve the landlord in a reversion to a former grantor, in the case of Indian Orchard Canal Co. v. Sikes, 8 Gray 562 (Mass.), a manufacturing corporation authorized by its charter to hold real estate, granted land upon condition "that no building or part of any building thereon shall ever be occupied or used for the sale of spirituous liquors." A grantee of the corporation's grantee leased parts of the land with buildings thereon to different persons, one of whom sold spirituous liquors in his tenement, without the participation, knowledge, or assent of his lessor. It was held that this did not entitle the corporation to enter for breach of the condition in its deed.

Likewise, where a deed contains the condition that "in case ardent spirits and wines shall be kept or sold on any part of the premises, the deed shall become void and of no effect," an unauthorized sale by a third person, without the fault or negligence of the grantee, will not work a forfeiture of the estate. Collin Mfg. Co. v. Marcy, 25 Conn. 242; see also Butterfield v. Wilton Academy, 74 Ia. 515, 38 N. W. 390.

Breach of Conditions

And it has been held that where the grant is to a municipal corporation, the corporation will not be deprived of title through the unauthorized acts of its officers in permitting a breach of the conditions. Moss v. Pittsburgh, 184 Fed. 325, 203 Fed. 247.

It thus seems that by virtue of the language of the deed proposed above, any breach by the mortgagor or lessee in the deed of trust would operate as a forfeiture of his term, and his position would then be that of a stranger whose unauthorized act in violating the restrictions would not operate as a forfeiture or reversion of the title. In other words, a life insurance company may safely and legally accept for investment a mortgage deed of trust in the above form without violating any statute of its State prohibiting investment in mortgages secured by titles subject to reversionary rights because of violation of restrictions, and all of this without the necessity of seeking waivers from the grantors in the original deed or their heirs.

Advantages

Another advantage of inserting the suggested provisions is that title insurance companies will be more disposed to insure against loss or damage because of possible future reversion if the deed of trust contains the above provisions.

To sum up, it appears that the foregoing may be a solution of the present problem confronting life insurance company legal departments, as to how desired loans may be accepted, where no violation of restrictions has occurred, even though there may be a reversionary or re-entry clause in the deeds creating the restrictions.

UTOPIA UNDER THE HAMMER

"Four million dollars of federal money and an unestimated number of millions of words were spent in creating a model community at Hightstown, New Jersey, in that golden age in which Doctor Tugwell and his associates were engaged in rebuilding America. Now it has gone under the hammer. Salvage practically nil. Almost no attention paid to its finish. Not even Dr. Tugwell sent flowers."—Herbert Corey in Nation's Business.

THE WAR AND BANKING

B. H. McCormack, writing in the Wall Street Journal, reports that deposits in the 19 large banks which are members of the New York Clearing House Association have increased approximately two and a quarter billion dollars in the period since the European war began. This represents a gain of almost one-fifth.

This tremendous deposit gain, Mr. McCormack points out, resulting from the flow of funds from abroad to the United States, is probably the outstanding development in the country's banking picture.

"Foreign money has sought safety here," writes Mr. McCormack. "That was going on, of course, prior to the war. But the actual outbreak of hostilities spurred the movement.

"Because of this flow of funds here the banks have watched their idle funds increase by leaps and bounds. As of the end of last August excess reserves of all member banks were $4,800,000,000. Now they're $6,880,000,000. In New York City alone this idle funds total has advanced from $2,821,000,000 just before the war to $3,570,000,000 now.

"At the same time the banks have found but little use for the larger balances which have come into their hands. Weekly reporting member banks in 101 leading cities—which institutions comprise a large part of the total banking assets—have added about $450,000,000 to their business loans since the war started. That's a gain of more than 10 percent but the level of such credit is very low.

"Meantime, the banks in New York City have added substantially to their holdings of U. S. Government obligations. Since the war began their portfolios of these securities have shown an aggregate increase of close to a billion dollars. All in all, the reporting member banks outside New York have shown a decrease in their Governments during the same period.

"The banking picture seems to add up to this: There are large amounts of idle funds in their hands and little prospect that any substantial part of them will be put to use soon. Add to this the fact that much of the weakness of the banking structure resulting from real estate mistakes of the 1920's has been erased and you have a system that is in good shape to meet the problems of wartime financing."

CAPITALIZATION RATES

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counted in estimating present (today's) worth, the rate should not be low, as in a sinking fund.

The present worth of one, collectible 50 years hence, is today 0.228, if discounted at 3 percent per annum; and is 0.021 if discounted at 8 percent. Stated differently, 22.8 cents deposited today and left at 3 percent per annum, compounded annually will amount to $1.00 at the end of 50 years. Similarly, 2.1 cents deposited in an 8 percent account will amount to $1.00 at the end of the same time.

In the latter case it is assumed that money can be safely invested at 8 percent compounded annually, for 50 years. While such an assumption transgresses the bounds of reason, yet the 8 percent factor is preferable to the 3 percent factor. This is for the very simple reason that because of the uncertainty of what the future may hold, and hence what the future value may be, and the probability of its collection, the estimate of the worth of the reversionary interest at its time of collection (in this case 50 years hence) is indeed a pure guess, fraught with uncertainties. In view of this condition a factor of safety should be injected into the computation, and this is accomplished when a high rate is employed.

The Profit

Profit as used here is that portion of the net income to the property in excess of the normal requirements, i. e., interest and depreciation on the building and a reasonable return on the land.

The rate at which profit should be capitalized is high indeed. Not uncommonly it should be 60 percent or even more. This is for the reason that profit is the least stable item of income. If any decrease in income does appear, profit is the first to suffer; and profit must vanish before the amount of the income imputable to any of the agents in production is affected.

Profit is, perhaps, the most illusive of all appraisal data. Why this is so is aptly expressed in one of the inexorable axioms of economics, "exorbitant profits breed ruinous competition." Not many years ago there sprung up the "miniature golf" craze during which countless numbers of vacant lots were improved with undersized golf courses under leases, which, when capitalized at prevailing interest rates, reflected values unbelievably greater than warranted and greatly in excess of cost. Similar situations existed with service stations, apartment houses and other types of real property.

Each gave witness of the inevitable attraction of capital to such ventures seeking high returns on the investment, with the result that competition entered and reduced the net incomes, not uncommonly to ruinous levels.

Profit cannot permanently exist. The normal tendency is for competition to dissipate the major portion of it, and for land to absorb the small remainder through increased land prices.

Factors Effecting Rates

Factors having the greatest effect on capitalization rates are:

1. *The price level,* meaning its stability or instability. During a rising price level, when rents and realty values are increasing and capital profit appears, the risk of ownership decreases, and interest rates tend to move in like direction. Conversely, when the price level falls, and rents and realty values fall likewise, a capital profit disappears, the risk of ownership increases and interest rates likewise move upwards. The so-called normal capitalization rates will prevail only when the price level is reasonably static.

2. *Economic conditions.* During periods of so-called normalcy, or when the price level is reasonably static, i.e., fluctuating within narrow limits or, stated still differently, when the agents in production are in equilibrium, by which is meant that the gross income to a property is sufficient to pay a reasonable return on the investment, then and during such times a well defined over-all rate will prevail. However, if the price level is moving upward, the risk rate will fall, tending to reduce the over-all rate; conversely, both the rate for risk and the over-all rate will increase.

3. *The desirability of the district.*

4. *The desirability of the type of property,* such as industrial as compared with residential income, or retail commercial.

5. *The ratio of land value to building cost.*

6. *The supply of and demand for funds.*

7. *The purpose of the appraisal.*

8. *Governmental policy* as exercised through the combined powers of the Treasury and the Federal Reserve Board.

The construction of the capitalization rate from its component parts has indicated a logical method of approach to the final over-all rate.

From the above discussion it is evident that the lowest rate will be applicable to that type of income which is considered the safest and surest—that which is comparatively free of risk.

The real estate income with the least risk comes from vacant business lots in the heart of the central business district. Usually it comes from adequately secured long-term ground leases. The rate applicable to such incomes is not uniform for the entire country, nor is it uniform in any city as variations are occasioned by changes in economic conditions and other factors. However, there is a "norm" toward which this rate tends to adjust in every city, particularly during times of relative stability in the price level and in interest rates.

Tendency to Stabilize

This tendency for the capitalization rate to stabilize more or less or to be limited to a small range is apparent in all classes of real estate and it has been my experience that the limits for the various types of property, during normal times, are as follows:

Ground Leases in 100 percent central business district locations	4½—5%
One and Two-story Store Buildings—proper and balanced improvements in 100 percent retail zones	5 —6%
Office Buildings—proper and balanced improvement in heart of central business district	6 —7%
Semi-Fireproof Automatic Elevator Apartments — proper and balanced improvement in stabilized areas	6 —8%
Fireproof Elevator Apartments — proper and balanced improvement in stabilized areas	6½—8%
Apartments—proper and balanced improvements in outlying areas — depending on the stability of the district	6 —9%
Hotels — proper and balanced improvements—convenience to central business district is of prime importance	8 —10%
Suburban or Secondary Business Properties—proper and balanced improvements	8 —10%

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AUGUST 15, 1940

Private Capital And Defense Housing

All members of the Mortgage Bankers Association of America should welcome the recent statement by Charles F. Palmer, newly-appointed Defense Housing Coordinator, promising that private capital would be called upon to supply additional housing needed in connection with the national defense program.

Mr. Palmer takes the position that private enterprise should be given the first chance to supply every type of housing necessary in cities where army and navy posts and key defense industries are located. If it becomes evident that private business cannot do the job after it has been given the chance, then a public agency should take over, in Mr. Palmer's view.

Prior to accepting the position as Defense Housing Coordinator, Mr. Palmer was head of the National Association of Housing Officials. He served twice as president of the National Association of Building Owners and Managers. Upon assuming his new position, Mr. Palmer made the following statement:

"The job of Defense Housing Coordinator under the direction of the National Defense Advisory Commission is to supplement, not supplant, any existing agency or service. It is for the period of the emergency only.

"General principles have been outlined by unanimous and friendly action of the Central Housing Committee which includes the heads of all Federal departments affected. The Defense Commission concurs.

"In doing the job, the primary objective will be to encourage the use of private capital. It is believed adequate safeguards can be added to the many already provided and that even during these uncertain times it will be good business for private capital to handle the requirements in most instances. Where it is not available, fails to respond, or finds it impracticable to act with the promptness required by the emergency then the Government will have to do the job.

"The duty of the Coordinator and his staff as outlined to me is to see that sufficient housing — private preferably, but if not, then public—is made available to meet emergency needs with such dispatch that national defense does not suffer."

APPRAISAL PLAN DEVELOPED

The appraisal of real estate held by insurance companies received considerable attention at the recent convention of the National Association of Insurance Commissioners.

A plan has been developed in Massachusetts for appraising real estate taken by insurance companies under foreclosure of mortgage. The plan has been in effect since December, 1939.

The Weekly Underwriter points out that the plan requires only one appraisal at the time the company comes into possession of the property. The plan also provides for a definite rate of depreciation which is believed adequate to cover any contingency likely to arise.

The Massachusetts plan follows:

1. This plan will apply for the present to Massachusetts real estate holdings only and will be extended to other states as soon as a list of appraisers is prepared.

2. The Massachusetts Department of Insurance has prepared a list of competent Massachusetts appraisers, whose qualifications are on file. These appraisers will make an appraisal of each property submitted in duplicate—one copy which shall be forwarded to the department of insurance and one copy will be delivered simultaneously to the insurance company, together with a bill for services rendered, which bill is to be paid by the insurance company for whom the appraisal is made.

3. When the real estate, on which a mortgage has been foreclosed, comes into the possession of an insurance company, immediate notice shall be given to the department of insurance in order that the names of three impartial appraisers may be submitted.

4. The department shall be immediately notified which of the three appraisers has been selected. The appraiser shall receive the following information from the company:

Location of the property to be appraised.

Assessed value.

Income and expenses for each of the past five years.

Amount of fire insurance and any other insurance presently carried, together with the co-insurance provision, if any, contained in the policies.

Age of the building.

Complete information relative to definite future leases, either signed or in the process of negotiation.

No other information should be furnished the appraiser.

5. The same procedure shall be followed on each parcel of real estate on which the company requests an extension of time beyond the five-year period. Two months' notice in advance of the date from which extension is to commence will be required by the department.

6. Extensions, which have already been granted, will not be subject to this plan, unless or until a further extension is requested. All extensions not already approved will be immediately subject to this plan. Every parcel of real estate, which has come into the possession of the insurance companies since July 1, 1939, shall be immediately listed and forwarded to the department in order that impartial appraisals may be called for.

7. The appraised value, as submitted by the impartial appraiser, if lower than the book value, shall be the company's future book value of the parcel, unless a valid objection can be sustained at a hearing which must be requested within fifteen days after receipt of the appraiser's report.

8. Any company, which at present maintains a reserve for depreciation of real estate, shall continue such reserve without reduction until at least 50 percent of the property in possession has been appraised according to this plan.

9. Provision should be made for reasonable, annual depreciation after impartial appraisal.

Make your plans now to attend MBA's 27th annual convention in Chicago.

NOTED EDITOR WILL SPEAK AT STAG DINNER

A discussion of foreign affairs at the stag dinner by Carroll Binder, foreign editor of the Chicago Daily News, promises to be one of the highlights of the 27th annual Convention of the Mortgage Bankers Association of America. The stag dinner, a feature of MBA's annual conventions, will be held on Wednesday evening, October 2, at the Knickerbocker Hotel.

Mr. Binder, who is regarded as one of the most astute observers of foreign affairs in this country, attended the University of Pennsylvania and was graduated with highest honors from Harvard in 1916. The following year he did graduate study at Harvard. From 1917 to 1919, Mr. Binder was a member of the Quaker unit of the American Red Cross engaged in civilian relief work on the French front. From 1919 to 1922 he was in newspaper work in the middle west.

CARROLL BINDER

In 1922, Mr. Binder joined the Chicago Daily News as a special writer specializing in sociological, industrial and political problems. He covered the Nicaraguan revolution in 1926 and 1927. From 1927 to 1929 he served as foreign correspondent of the News in Italy. In 1929 he was assigned to Soviet Russia and during the years of 1930 and 1931 he was a correspondent in London.

From 1931 to 1937, Mr. Binder was editorial assistant to the publisher of the News, Col. Frank Knox, and was engaged in writing editorials on foreign affairs. In 1937 he was made foreign editor of the News and director of the foreign service. During 1934 he travelled extensively in Japan and China.

Mr. Binder has contributed to numerous journals including the Annals of the American Academy of Political Science and Public Opinion. He is the author of "The New Negro in Chicago."

He is a trustee of the American Institute of Pacific Relations and a member of the Executive Committee of the Chicago Council on Foreign Relations. Early this month Mr. Binder returned from Havana where he covered the Pan American Conference.

CAPITALIZATION RATES

(Continued from page 6)

In suburban business property the unearned increment plays an important part in fixing the capitalization rate. This is particularly true when the population is rapidly increasing and providing increased purchasing power to rapidly develop the trading area. In such cases the rate might be as low as 5 percent.

Frequently appraisers or appraisal firms are employed to appraise a large number of properties for a financial institution. Usually the purpose of these appraisals is to bring up to date the valuations of the properties on which the institution has made first mortgage loans.

In one such instance known to the writer and involving some 1,200 properties, it was felt that the final rate should be built up by establishing a base rate and adding to this base rate factors to take care of individual variations in location, desirability and trend.

Accordingly, the base rate was set up as follows:

Interest rate being paid on deposits	2 %
Institution's cost of doing business	½%
Reserve against increase in interest rate paid and increase in cost of doing business	1 %
Reserve for losses and other contingents	1½%
Total base rate	5 %

To this base rate were then added penalty percentages based as follows:

Location Penalty	Excellent	——
	Average	1%
	Poor	2%
Desirability Penalty	Especially	——
	Average	1%
	Undesirable	2%
Trend Penalty	Upward	——
	Level	1½
	Downward	2%

This resulted in a property excellently located, especially desirable and with an upward trend, having a final capitalization rate equal to the base rate of 5 percent.

The other extreme would be a property poorly located, undesirable and with a downward trend, having a final capitalization rate of 11 percent.

No brief is held for this approach. It is an attempt to avoid individual estimating of the rate as a whole and to produce a reasonable degree of uniformity. The same idea can be adapted to various appraisal problems and should be of assistance in justifying the rate selected.

MBA ISSUES LOCAL CHAPTER NEWS

With the publication of the first issue of MBA Local Chapter News, the Mortgage Bankers Association of America this month inaugurated a new service for the benefit of members of local mortgage bankers organizations affiliated with the MBA.

Local Chapter News is edited from the Headquarters Office and will be issued each month. Each issue will contain articles concerning the activities of various local associations.

Byron T. Shutz, President of the MBA, declared that one of the primary objectives of the Local Chapter News is to provide a medium for an interchange of ideas between local chapters.

"This publication will fill a service that The Mortgage Banker does not undertake," President Shutz said. "The Mortgage Banker will continue to carry articles of broad, general interest to all persons engaged in the mortgage banking business. The Local Chapter News will be more specialized, and deal with local problems.

"The Local Chapter News is not intended to replace the splendid monthly bulletins which several local chapters are already publishing. The sole purpose is to knit our local associations more closely together by serving as a clearing-house for useful information."